CHAPTER 23
TAIWAN

Introduction. Not long ago, Taiwan was a global IT powerhouse.

- For more than four decades, Taiwan enjoyed 6% average economic growth.
- Compared with mainland China, Taiwan always seemed economically superior by almost any yardstick.

Recession. Not anymore. Those days are gone.

- An unexpected reversal in cross-Strait economic fortunes has left Taiwan suffering its first full-year contraction in at least half a century even as the mainland continues to enjoy impressive growth.
- GDP growth fell from 6% in 2000 to -1% in 2001, their biggest fall on record.
- Taking 2001 and 2002 together, average GDP growth in Taiwan may be the slowest over any two years in the past three decades—slower even than in 1997-98.
- As GDP falls, Taiwan's debts become more burdensome.
- Why is this happening?

Current Economic Challenges

Taiwan now faces three difficult and related economic challenges.

- Global IT Glut
- Structural fault-lines (especially a broken financial system), and
- The mainland's magnetic investment pull.

Possible Impact. Together, these three challenges may turn the government's policy toward the mainland upside down.

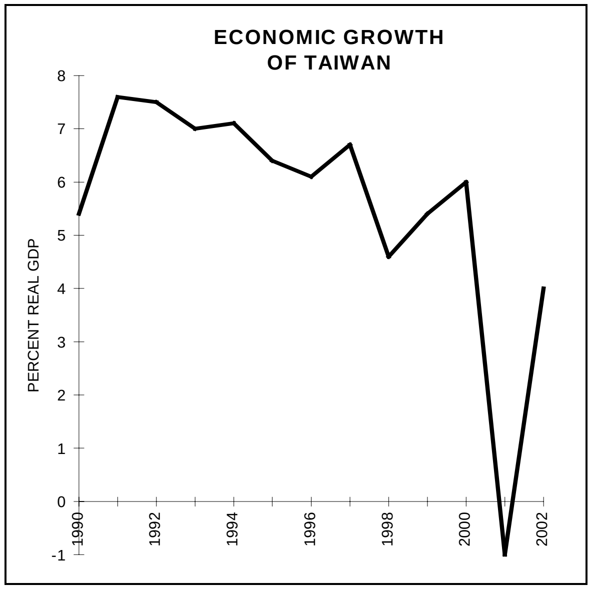
- To survive the turmoil, Taiwan's society and economy needs to reinvent itself.
- If Taipei orchestrates a successful social and economic transformation, the result could well be economic integration and peaceful coexistence with the mainland.
- If Taiwanese nationalism prevails and economic integration is politically thwarted, the result could be war with the mainland.
- The USG should continue promoting peaceful societal transformation and economic integration with the mainland.

Figure 23-A. Selected Historical Data

$ Billions (or %)	'97	'98	'99	'00
Gross National Income	290.2	267.2	287.9	311
Purchasing Power	327.0	362.0	357.0	376.6
Real Growth (%)	6.7	4.6	5.4	6
Inflation (%)	0.9	1.7	0.2	1.3
Exports	121.3	110.4	121.4	147.8
To U.S.	33.7	34.3	36.4	41.9
Imports	114.1	104.7	110.8	139.9
From U.S.	20.4	18.2	18.9	23.8
FDI from U.S.	4.9	4.9	6.5	7.7
In U.S.	2.9	3.2	3.0	3.2
Cur Account /GDP %	2.4	1.3	2.9	2.4
Fiscal Balance /GDP %	0.1	1.4	0.1	-0.5
External Debt /GDP %	11.6	11.6	..	..

Sources: IMF, ADB, World Bank, U.S. Commerce

Figure 23-B



First: High Tech Falls

Taiwan has been a victim of the disastrous decline in demand for IT-related products that in the past accounted for about 40% of Taiwan's exports by value.

- The IT glut has left Taiwan's world-class computer firms and chipmakers reeling.
- The IT glut has pushed unemployment close to 5%.
- GDP is shrinking by 1% in 2001 as IT exports continue to fall.
- The U.S. and global recession and 9-11 attacks only deepen the weak demand for IT goods.
- Pressure is also mounting on the government to strengthen the welfare

safety net—and offset the disruption caused by two recent typhoons.

- That said, the government's first task must be to diversify and counter the effects of the vicious downward swing in the global electronics cycle.

Second: Structural Fault-lines

Policy Mistakes. While it's difficult to blame the government for the global glut in IT goods, Taiwan's economic downturn is also the result of failures of policy.

- Taiwan's investors believe that the island's economic woes are structural rather than just the result of the IT glut.
- For instance, the enfeebled banking system cramps long-term growth.
- So Taiwan's investors have been heavy sellers for more than a year.
- For instance, Taiwan's officials and politicians have known for years that the financial system needs an overhaul.
- But reforms have been repeatedly delayed, and it is only now that serious change appears to have begun.

Financial Socialism. Tough action to streamline the government and increase administrative efficiency has been blocked as many times as it has begun.

- Many companies in traditional industries such as construction or textiles have been half-dead for many years.
- These dinosaur firms are kept alive with state-directed loans and ad-hoc handouts.
- Such corporate and financial socialism has high opportunity costs.
- Government help for the worst companies hinders the better-run firms. They unfairly outbid healthy and efficient firms.
- These sick and inefficient firms don't finish their work on time and have poor quality.
- Taipei must opt for "creative destruction."
- In other words, the government should stop saving the sick and inefficient firms that are not competitive and shift capital to greener pastures.

Bad Loans. As a result of this corporate and financial socialism, the number of bad loans has soared. The government must respond.

- Bank bad loans need to be recognized and addressed.
- Hopeless borrowers need to fail.
- To make matters worse, Taipei must also tackle bad loans without putting excessive strains on the public finances.
- The fiscal deficit is already forecast to rise to 6.3% this year as a result of increased government spending and a fall in corporate tax revenue.
- That will be a difficult balancing act.
- But addressing the bad loan problem is not the only economic reform Taipei must address. See below.

Other Economic Reforms. The focus of Taiwan's efforts should be on upgrading its economy and finally implementing reform.

- Impending accession to the World Trade Organization will help shake up agriculture and some manufacturing sectors.
- But Taipei will have to avoid easing the pain with subsidies alone.
- The government must also give up the habit of frequent intervention in the politically important stock market.
- Land and labor laws need more flexibility.
- The tax base needs to be widened.
- And a more complete welfare system needs to be introduced to help solve the social wounds inflicted by such actions.
- It is a challenging task list, but Taiwan many advantages.

The Laundry List. In response to these challenges, the government convened an economic advisory conference in July 2001 with a view to forging a new political consensus about how to proceed.

- The business leaders, officials, and economists who participated in the meetings came up with 322 "unanimous proposals" for reinvigorating the economy—including pursuing faster financial reform and lifting more restrictions on cross-straits business ties.
- But the implementation of these recommendations was stalled by the legislative elections in December 2001.

Taiwan's Economic Strengths. Despite the daunting list of reforms, Taipei has numerous economic strengths that should help them weather the storm.

- Firstly, there is a high degree of consensus about the direction of reform, even if there are still bitter battles taking place over important details.
- Also, unlike in Taiwan's northern neighbor Japan, there is no protectionist social contract that needs to be re-written; the pervasive ideology is pro-business even if past policies have not always been particularly market-minded.
- Small and medium-sized businesses remain a font of entrepreneurial energy, with ventures eagerly searching for niches to exploit in sectors ranging from biotechnology to computer chip design.
- And Taiwan still boasts some of the world's most competitive companies and an educated and adaptable workforce.

Third: Economic Integration with Mainland

Meanwhile, in a nationally broadcast "New Year Address" for 2001, Taiwan President Chen Shui-Bian's called for the integration with mainland economies, trade, and culture as, "a starting point for gradually building faith and confidence in each other."

- This is consistent with his conciliatory message in his May inaugural address.

Multiple Messages. The speech conveyed messages to Beijing and his own DPP political party. So he had to strike a delicate balance.

Message to China. Economic, trade, and cultural integration falls short of Beijing's call for a "one China principle."

- But it was constructive.
- It provides assurances to Beijing that Taiwan is not moving toward political independence.

Message to his own DPP. Economic integration goes further than many DPP hard liners are comfortable with.

- He has not convinced skeptics in his own party to totally support the proposal.
- DPP is aware that he is not giving away sovereignty in the short run.

Net Assessment. Economic integration is a good compromise.

- Chen has proposed a process of cooperation aimed at creating enough confidence between the two sides to enter into undefined political cooperation at some point in the future.

Shared Prosperity. Chen is attempting a difficult balancing act that may unravel. But his political challenges should not diminish his insightful message.

- Economic, trade, and cultural integration is arguably the most promising way to finesse sovereignty and move away from the brink of conflict in the straits.
- Economic integration gives both sides a stake in shared prosperity. They realize they have a lot to lose if they opt for war.
- That makes war less likely, although still possible. In contrast, economic nationalism makes war more likely.
- USG should work closely with both sides to shape an economic strategy.

Strategic Vision. Chen's call for economic integration starts to codify and provides an insightful strategic vision for an economic trend that is picking up speed and shows promise.

- On January 2, 2001, mini-links were established in trade, transport, and postal services between China and Taiwan.
- This reflects Taipei's unilateral decision to allow limited exchanges, thereby easing a half-century ban on direct trade.

Mutual WTO Entry. Both China and Taiwan are expected to further open direct links following their entry into the WTO.

- The mini-links policy could lead to significantly better bilateral relations.
- The financial implications of direct links between China and Taiwan for mainland cities are huge.
- In February 2002, one of a series of measures aimed at reducing barriers for companies doing business with China was implemented. Taiwanese banks with domestic banking units are now able to remit money to and from the mainland.

- Economic equities could well outweigh political strains and military tensions.

Trade. Since 1987, when the Taiwanese government began allowing people from Taiwan to visit relatives on China, cross-strait trade and economic relations have rapidly improved. The results are impressive:

- As of November 2000, total indirect trade with the Chinese mainland amounted to $184.4B, of which Taiwan had a trade surplus of $130B.
- Cross-strait trade was nearly $30B.
- Taiwan imports were up 34% and exports up by 32%.
- Taiwanese businesses had a trade surplus of nearly $20B.
- Taiwan-China trade increased 22% from January through November 2000, compared to the same period in 1999.
- Taiwan is the fifth largest trade partner and the second largest source of imports for the mainland.
- Economic analysis reveal that trade and investment have accounted for 2.5% of Taiwan's economic growth rate.

Investments. Taiwan investment in China is also impressive.

- Taiwan investment in China for the first ten months of 2000 was $2.5B, an increase of 21% over same period in 1999.
- Up through October 2000, the number of contracted investments by Taiwan businessmen on the mainland reached 45,729, totaling more than $46.5B, an increase of 32%.
- More than 30,000 Taiwan factories or Taiwan-connected factories are operating on Chinese mainland.
- Approved Taiwan investments in China January to October 2000 increased 98%, with over half of the investments going into the electronics sector.

Nature and Flow of Investments. Investments into China occurred under restrictive trade measures compared to natural occurrence prior to 1996. Investments were directed at China's domestic trade.

- Investment flows into China have spread from southeastern coast areas to central and western regions.
- Investment is centered in Shanghai, Guangdong, and Fujian coastal areas.
- Taiwan investment shifted from small-to-medium enterprises to medium-to-large enterprises.
- Investments focused on capital-intensive and network-related technology sectors.
- Electronics manufacturers accounted for 60% of total investment volume in 2000. This trend is a shift from previous traditional processing industries.
- Significant capital shifted from the Taiwan stock market to China stock market.

WTO Driver. Successfully arriving at a bilateral agreement between the United States and China prior to China's impending entry into the WTO was another factor contributing to the boost in Taiwan investment.

Impact of WTO Entry ***.*** WTO accession of both China and Taiwan would lead to further opening of China's domestic market.

- Cross-Strait trade policy will be adjusted—particularly by China—while liberalizing financial, business, telecommunications, insurance and travel markets.
- Both Taiwan and China would reap huge economic benefits with diminished trade and investment restrictions.
- The implications for improved and expedited trade links would mean increased investment incentives for manufacturers from Taiwan and other foreign countries, especially those engaging in export-oriented and high-tech industries.

Shared Prosperity. China and Taiwan have economic interests that complement rather than compete with one another. In short, they are natural economic partners.

- On a comparison basis, Taiwan's businesses are small in scope—lack high-tech personnel—and markets are narrow.
- China has comparative advantages in high-tech personnel, rich natural resources, and a broad market scope.

These characteristics are an attractive investment pull.

- Trade links could greatly reduce the cost and time required for freight deliveries.
- With more Taiwanese investments in China, particularly in the high-tech sectors, the division of labor and cooperation between the two countries would increase.
- Overall, intensified cooperation and resource sharing would be mutually beneficial to China and Taiwan.

Realized Investment. Skeptics point to the fact that for the past year or two, the amount of realized investment from Taiwan has fallen about 14%. Why the drop? Two factors:

- Renewed tensions in the cross-straits.
- Taiwan's restrictive trade policies limit investment flows across the strait.

No Haste, Be Patient Constraint. One of the restrictive policies impeding Taiwan's realized investment in China has been the "No haste, be patient" policy, which has been in place since 1996. Capital investment in China's high-tech sectors was not permitted and therefore usually channeled through Hong Kong, Singapore, or the Virgin Islands. Under the "No Haste, Be Patient" policy, Taiwan barred enterprises specifically from:

- Making single investments over $50M.
- Investing in high-tech or infrastructure projects.

Taiwan President Chen Shui-bian took a pragmatic approach to dealing with the mainland, despite expressing pro-independence sentiment before he was elected in 2000.

He scrapped the $50M ceiling on single investments in China and, prior to parliamentary elections on 1 December, gave the go-ahead for Taiwanese firms to make certain hi-tech products in China.

In 2000, only 1% of the profits from investments in China returned to Taiwan in 2000. Most profits were held in banks in third countries, primarily Hong Kong.

- Easing of the trade restrictions would allow Taiwan to reap investment returns. That in turn would give Taiwan a greater stake in shared prosperity, economic integration, and political cooperation.
- China, as direct beneficiary of Taiwan's investments, would develop a greater stake in shared prosperity, economic integration and political cooperation.

Mainland Magnet. And, just as cracks are starting to appear in its economic miracle, Taiwan faces unprecedented commercial challenges from mainland China.

- Lured by the magnetic pull of a growing mainland economy, Taiwanese companies are shifting production across the straits.
- Cheap land and labor are obvious lures.
- Business leaders argue that Taiwan's shortages of land and labor leave them little choice but to invest in China.
- Local engineers cost just one-fifth of those at home.

Changing Perceptions. Taiwanese companies are also viewing the mainland in other positive ways as well.

- In the past, most focused on China for export production no longer viable in Taiwan.
- Now, even advanced computer chip producers see China as an important market.
- Officials used to comfort themselves that at least management, capital raising, and research and development could be kept at home.
- But now many companies plan to list on mainland exchanges.
- Taiwan firms are also training mainland managers and moving high-value operations.
- As a result, Taiwan firms do not just bring over the production lines.
- Taiwan firms also bring over R&D.
- Due to the larger customer base, sales could be much higher on the mainland.
- Corporate Taiwan also stands to benefit from Taiwan's and China's near simultaneous WTO entry, which will open the world's most populous market and its integration in the world economy.

China's Dynamic Coast. While most of the mainland remains decades behind, China's dynamic coastal cities are often more advanced than those in Taiwan.

- Shanghai boasts infrastructure that tempts even the advanced electronics companies dominating the Taiwanese stock market.
- Mainland universities are producing electrical engineers to complement cheap line workers from inland provinces, while officials offer tempting tax packages.
- Taiwan can hardly compete on raw cost, but some investors are even saying that mainland innovations such as "one window" project approval—long talked about in Taiwan but still elusive—are making doing business in China not just cheaper but also easier than at home.
- Facilities and construction quality already surpass Taiwan in a number of areas.

Relative Calm. Meanwhile, this focus on cross-strait economic battlegrounds underlines the relative calm of overall ties.

- There has been little of the mainland saber rattling that preceded Taiwan's presidential election in 2000.
- Nor has there been any return to the tensions sparked by the 1999 attempt by Lee Teng-hui, the former Taiwan president, to redefine relations as "state-to-state."

Economic Threat? While the mainland's missile threat to Taiwan persists, zero sum economists in Taiwan feel that most pressing challenge might come more from their communist rival's commercial strength than the People's Liberation Army.

- *Taiwan Business Leaps Straits****.*** While Chen Shui-bian, Taiwan's president, has confounded the fears of many by avoiding confrontation with Beijing, his government is struggling to find ways to stem—or at least to manage—a rush of businesses eager to leap the political gulf between the two sides of the Taiwan Strait.
- *Policy Change****.*** While Chen has scrapped Taipei's five-year-old "No Haste, Be Patient" policy on mainland investment in favor of "Active Opening, Effective Management," officials are divided as to what the new approach will mean.
  - On the one hand, Taipei has scrapped a $50M ceiling on individual projects. Taipei ordered a "limited opening" for offshore islands and offered to discuss the issue with Beijing.
  - On the other hand, the policy has been adjusted rather than totally relaxed. A real open door policy is still not a reality. In fact, Taipei will retain limits on total mainland investment.

Future of "One-China." Mainland insistence that Taiwan must accept the principle that there is "One-China" before it will hold any talks means links are likely to remain limited.

- That said, China could find it harder to insist on its "One-China" principles when it comes to trade.
- Why? WTO entry will change everything.
- The impending accession of both sides to the World Trade Organization will create a whole new forum for contacts.
- In the past, China has insisted that its "internal" ties with Taiwan have no place in an international organization.
- The "One-China" fixation could prove hard to sustain once both sides are in WTO, an institution with little interest in sovereignty issues.

Closer Economic Integration? Meanwhile, the longer-term strategic question facing the government is how it pursues closer economic integration with Mainland China without compromising its political claims to autonomy and its own identity at home.

- Taiwanese companies have invested about $60B in Mainland China.
- These Taiwanese firms employ as many as three million workers.
- Many business leaders are convinced that they must shift even more production to the low-cost mainland if they are not to lose out to competitors from Japan, the United States, and Europe.

The Great Debate. In the short run, the logic may be compelling for Taiwan's companies to invest more and more Taiwanese capital on the mainland.

- Short-term opportunities to make a profit are more promising on the mainland than in Taiwan.
- But is Taiwan getting overly exposed if the Chinese economy were to turn downward?

Too Dependent? At the moment, China's economy is reportedly growing at about 7%.

- But how durable is this mainland growth?
- The state owned enterprises on the mainland are seriously over-borrowed and the Big Four state-run banks are insolvent.
- In this sense, the financial quicksand so apparent in Taiwan's own financial system may well be even worse on the mainland.
- Over the longer run, the mainland has a highly risky market and is therefore a highly risky partner to do business with.
- This zero-sum economic school says that what is a good quick buck for corporate Taiwan may not necessarily be so good for the Taiwanese population as a whole over the long term.

Policy Debate. Despite the policy adjustments, Taipei is divided over how fast to open commercially to China in the future.

- On the one hand, the nationalistic Mainland Affairs Council—the body responsible for China policy—stresses the need to avoid becoming dependent on Beijing. Such caution raises corporate hackles, but is understandable.
- Beijing is willing to mix politics and business.
- In 2000, firms considered too close to Chen came under pressure from the mainland.
- In 2001, China punished one international investment bank for organizing an overseas investment promotion led by Taipei's finance minister.

Shared Prosperity? On the other hand, the “shared prosperity” economics ministry talks of rapid liberalization of banned high-tech and large-scale investments.

- The economics ministry makes a persuasive positive sum argument that the financial security of the island and the mainland would be stronger and long term economic growth for both would be more durable if the mainland and the island increased economic integration.

Corporate Culture Challenge. Critics on Taiwan also say the mainland is "hollowing out" the island's industrial base.

- But clinging to its manufacturing base is no vision for Taiwan’s future.
- Eventually Taiwan needs to “go up-market” and make the shift from a predominantly manufacturing-based economy to one based more on services, research, and development.
- This shift would also be a recipe for any harmonious economic integration with the mainland, with each side focusing on its comparative advantage.
- Only then can Taiwan’s economy hope to absorb the labor shed by the shift of manufacturing capacity to the mainland.

Conclusion

Can Taiwan Change? Questions are being asked about whether the Taiwan economy will be able to reinvent itself.

- After all, such a shift in Taiwan's economic strategy ultimately requires a dramatic change in Taiwan's corporate culture.
- Many Taiwanese companies would have to change the way they operate.
- And many Taiwanese people would have to change the way they think.
- That will be no easy task.